ATTACHMENT

State Corporation Commission Comments on Stranded Costs Recovery, 1997-98

Comments from "Draft Working Model for Restructuring the Electric Utility Industry in Virginia," November 1997

Up-front calculations "a recipe for disaster"

"To the extent public policy provides for some recovery level of stranded costs and stranded margins, policy implementation will be extremely complex. As indicated previously, stranded costs and margins are dynamic since they are directly dependent on the future market prices of electricity over the remaining life of the utility's generation-related assets. Any policy implementation which locks in stranded cost recovery up-front based on projections of long-range market prices for a market structure that does not currently exist may be a recipe for disaster." (Draft Working Model, p. 88.)

Sensitivity to market prices

"The dangers of a one-time administrative determination of stranded costs and margins should be made evident by Virginia Power's recent alternative regulatory plan filing with the Commission in Case No. PUE960226. In the filing, the Company provides an example stranded cost calculation under a given set of assumptions which reveals an approximate Virginia jurisdictional stranded cost exposure of $2.5 billion. However, a change in projected market prices of 15%, up or down, could either eliminate or double, respectively, the stranded cost calculation." (Draft Working Model, p. 88.)

Reliance on flawed assumptions, models

"Staff is especially concerned that current estimates of long-term market prices may be biased to the downside, thereby resulting in overestimation of stranded costs or underestimation of stranded margins. First, the Staff believes that there is a natural tendency of long-term projections to be unduly influenced by perceptions of current conditions, in this case the perception of excess capacity reserves and depressed electricity market prices. Secondly, the economic model upon which most of these market price projections appears to be based in the perfectly competitive model where prices approach marginal costs. This perfectly competitive model assumes that producers are price takers and fails to recognize many of the potential market aberrations that may characterize a competitive electric generation industry." (Draft Working Model, pp. 88-89.)

Divestiture unreliable in quantifying stranded costs

"An alternative to administratively calculating stranded costs is to require or encourage the sale of generating assets, thereby allowing the market to directly assess the value of those assets…However, in addition to being a rather drastic action for purposes of determining stranded cost, the Staff believes there is a significant risk that the short-term bias of the market might undervalue capacity, given the current perceptions of excess capacity. A large amount of generation capacity offered for sale at one time could further exacerbate this effect and result in higher stranded cost than might truly be justified." (Draft Working Model, p. 90.)

Comments from "Presentation to the Task Force on Stranded Costs and Related Issues" by Richard J. Williams, Director of Economics and Finance, State Corporation Commission, May 26, 1998

Erroneous estimates "could prove disastrous"

"Those types of possibilities beg for the greatest amount of flexibility possible to be built into the process for determining stranded costs. I hope you don't mind my making a brief editorial comment, but policy implementation which locks in stranded cost recovery based on long-range forecasts of market prices under a market structure that does not currently exist could prove disastrous." (Williams' comments, p. 10.)

Extreme sensitivity to market prices poses barrier to successful calculations

"In particular, it will be very difficult to administratively calculate stranded costs and stranded benefits. As previously discussed, stranded costs or benefits are the difference between regulated, embedded-cost rates for electricity and competitive market prices. Their calculation will require a forecast of what the embedded cost of existing generating assets would be over the life of the assets as if regulation continued and then discounted back to today's present value. We would have to compare this forecast to another forecast of what the market price of electricity would will be over the same time frame, once again discounted back to the present.

"I don't think I have to tell you the number of assumptions that would be involved in each of those calculations…A change in the projected market price of 15 percent up or down could either eliminate or double the stranded cost calculation." (Williams' comments, pp. 8-9.)

"Lost revenue" approach to stranded costs endorsed

"First, stranded costs are actually a reclassification of existing costs, they are not a new cost. The costs that may potentially be stranded are reflected in current electric rates. Regulated rates are based upon the actual cost of providing electric service. The assets that are in danger of becoming stranded are sometimes referred to as strandable costs.

"That brings me to fact number two: there can be no stranded costs until there is competition. As long as the strandable costs are in a utility's rate base and are included in the rates charged customers, nothing has been stranded and the utility is being fully reimbursed for the assets it uses to provide service." (Williams' comments, p. 2.)

Comments from introduction to "SCC Draft Stranded Costs/Benefits Legislation," July 1998

Flexible recovery method necessary

"If the General Assembly decides that at least some portion of stranded costs should be recoverable, we suggest a legislative approach to the determination and recovery of such costs that is specifically aimed at maintaining reasonable and necessary flexibility with respect to

policy implementation and administration. We believe that this flexibility is critical to serving the public interest of Virginia in that such a process entails substantial complexity and uncertainty, poses potentially significant public impacts, and must address the unique circumstances of each utility…It is essential that rigidity not be incorporated in one component of the transition process that may unintentionally undermine the ultimate objective." (Draft SCC submission, p. 1.)

Stranded costs hard to calculate

"Stranded costs and benefits are dynamic and cannot be accurately determined at this time, or even closely approximated. Proper estimation of stranded costs and benefits requires projecting market prices and costs over the remaining useful life of each existing asset or contract. In some cases existing utility assets may have a remaining useful life of over 30 years." (Draft SCC submission, p. 2.)

"Long-term market prices of a sensitive, non-storable essential produce with highly volatile weather-sensitive demand, simply cannot be estimated within the bounds of reasonable accuracy." (Draft SCC submission, p. 2.)

"A 15 percent change in market prices in an example stranded cost calculation provided by one utility would either double or eliminate a $2.5 billion base estimate of stranded costs. Cost projections of existing assets are also extremely questionable due to factors such as potential life-extensions and significant new environmental regulations with disparate impacts. An additional complication will be the allocation of embedded costs between competitive services and services which may continue to be subject to some form of price regulation such as certain generation-related ancillary services or must-run units.

"In short, reliance on a one time up-front estimate of stranded costs and benefits presents the potential for a public policy disaster," the introduction concluded. (Draft SCC submission, p. 2.)

#153644